

Commission, incumbent LECs, particularly small LECs that have remained under rate-of-return regulation, must be allowed an opportunity to recover all prudently incurred embedded costs.

A. Changes in Access Rate Structures and Universal Service Funding Must Be Coordinated.

The NPRM recognizes that changes in access rate structures and universal service must be coordinated and that access charges have played a significant role in funding and maintaining universal service.⁵¹ The NPRM also notes that a “double recovery” must be prevented and requests comments regarding how to prevent such a result.⁵²

It is clear that access charge revenues have played a very significant role in keeping local service affordable, an express goal of the Act. Local service rates (or the universal service fund) must necessarily increase if access charges paid by IXC decrease, because a LEC must recover its actual investments and actual operating expenses to remain in business. While it is necessary that a double-recovery of investments be prevented, it is no less necessary that LECs be allowed an opportunity to recover all prudent investments. If a change to forward looking costs is adopted by the Commission, recovery of the difference between a LEC’s embedded costs and forward-looking costs, by either a per minute CCL, a per minute surcharge, or by bulk-billing to the IXCs is needed and would not violate Section 254.⁵³

B. Forward-Looking Costs Will Be Less than Embedded Costs.

The NPRM recognizes that access revenues would be substantially reduced if all access services were priced at forward-looking, economic costs.⁵⁴ The Minn. Indpt. Coal. does not support requiring all LECs to adopt such an approach and has not conducted a TSLRIC study of

⁵¹ Id. ¶ 244.

⁵² Id.

⁵³ Id.

⁵⁴ Id. ¶ 248.

access charges (or a TELRIC study of network elements). However, it is clear that there would be dramatic adverse effects on local rates for Minn. Indpt. Coal. member subscribers (or significant increases in universal service funding requirements) if the Commission adopts any radical reductions in interstate access charges because LECs must replace lost revenues needed to recover actual investments and actual operating costs to remain in business and provide service. In 1995, interstate access revenues were over \$12.00 per line per month for all Minn. Indpt. Coal. members (over 260,000 access lines), exceed \$30.00 per line per month for 25 members (approximately 43,000 access lines) and averaged \$22.00 per line per month.⁵⁵ Increasing local rates by the amounts needed to replace these interstate revenues would certainly violate the universal service provisions of the Act.⁵⁶

While the Commission can increase the federal universal service funding, to replace some or all of these revenues, the consequences of such a decision should be carefully evaluated. Failure to establish a mechanism for recovery of such amounts, however, would impose a particularly severe burden on small LECs (and may threaten their continuation), which would violate clear constitutional requirements.⁵⁷ Such results must not be imposed by the Commission.

C. The Difference Between Forward-looking and Embedded Costs Results from the Combination of Regulatory Policies and Changes in Technology.

A number of questions have been raised regarding the source of the difference between LECs' embedded costs and their forward-looking costs. Possible sources of the difference that

⁵⁵ See, Discussion at I.B. above.

⁵⁶ Section 254(b)(3).

⁵⁷ NPRM ¶ 259.

have been noted include: 1) misallocation of costs to the interstate jurisdiction⁵⁸; 2) under-depreciation of incumbent LEC assets⁵⁹ resulting from the introduction of new technology which shortens the useful life of older technology⁶⁰; and 3) under-depreciation resulting from a decline in replacement value when new facility costs are less than the costs of the existing facilities.⁶¹

The adverse impact of each of these sources of under-depreciation can be directly traced to regulatory policies, including both: 1) universal service requirements imposed on LECs, which require LECs to make investments to provide high quality service to customers as their needs arise,⁶² and 2) limitations on LECs' depreciation rates imposed by the Commission and state regulatory bodies.⁶³ The impact is particularly clear for small LECs, which have remained under rate-of-return regulation by the Commission.⁶⁴

Addressing this problem requires both: 1) that the accumulated under-depreciation be recovered (through surcharges, bulk-billing or other appropriate mechanisms); and 2) that ongoing depreciation rates more accurately reflect technological change and other competitive realities.

The question is raised whether a market-based approach would fully satisfy the Constitutional requirement to allow recovery of prudent investments.⁶⁵ While a market-based approach may increase the prospects for recovery, it by no means assures that such a recovery

⁵⁸ NPRM ¶ 249

⁵⁹ NPRM ¶ 250

⁶⁰ NPRM ¶ 251

⁶¹ NPRM ¶ 252.

⁶² See, e.g., Minn. Stat. § § 237.06, 237.068, 237.081. The assumptions of perfect knowledge of customer locations and the use of only the most efficient state of the art technology, which underlie some forward looking cost models, can not be achieved by a LEC which meets ongoing universal service obligations as customer needs arise.

⁶³ See, Minn. Stat. 237.22 and 47 USC § 152 and 47 CFR § § 32.2000, 43.43, Part 69.

⁶⁴ 47 CFR § 69.3.

⁶⁵ NPRM ¶¶ 256, 261.

will occur. As discussed above, the underrecovered costs reflect the failure of regulation to adequately allow recovery of prior costs. New competitors will not have similar costs. Therefore, market pressures may not allow incumbent LECs to recover their previously unrecovered costs.

Further, whatever the merits of the arguments that “price-cap regulation” has allowed LECs the required opportunity for recovery of investments, such arguments are inapplicable to LECs that have remained under rate-of-return regulation⁶⁶. Similarly, the references to potential new sources of revenues (such as in-region long distance) may apply to the BOCs but do not apply to Rural LECs.⁶⁷ There is no “off-setting gain” for Rural LECs under the Act, unlike the ability to provide in-region long distance that is provided to the BOCs.

The adoption of a special regulatory mechanism to recover accumulated underdepreciation would not justify a specific limitation on incumbent LECs earnings.⁶⁸ This issue, however, is not relevant for rate-of-return LECs, which are already required to refund to IXC all earnings over authorized levels under the current mechanism of access charge regulation applicable to NECA companies.⁶⁹

It would be totally inappropriate to impose on LEC shareholders the losses resulting from under-depreciation that resulted from the Commission and state regulatory agency decisions.⁷⁰ Under the Fifth Amendment to the United States Constitution, the LEC shareholders cannot

⁶⁶ NPRM ¶ 256. NECA rate levels have been reviewed and adjusted from year to year to limit the return to the authorized level, which effectively precludes recovery of interstate investment beyond the depreciation rates used in establishing the rates, which depreciation rates were controlled by the Commission.

⁶⁷ NPRM ¶ 256.

⁶⁸ NPRM ¶ 265.

⁶⁹ Id. ¶ 265. See, e.g., Comptel.

⁷⁰ Id. ¶ 267.

legally be required to incur the costs of a regulatory paradigm shift.⁷¹ Rather, regulators are required to fulfill the existing “regulatory contract”, including allowing LECs to recover related costs, before a new mechanism can be imposed.

D. There Is No Factual Basis to Conclude that Any Small LEC Has Over-Invested.

The NPRM requests comment whether there is a basis for disallowing costs resulting from “over investment and other inefficiencies.”⁷² The basis for this request for comments are the Hatfield Study and a letter from AT&T dated November 22, 1996. Even if the Hatfield Study was accepted at face value, it would provide no basis to adjust small LEC investments.

It is widely recognized that the Hatfield Study is based entirely on data relating to the BOCs and that the Hatfield Study does not reflect any cost-data from rural LEC areas. Accordingly, there is no basis to conclude that the Hatfield Study has any probative value with respect to investments made by, or costs incurred by, rural incumbent LECs.

Further, it is clear that it would be highly inappropriate and completely unlawful for the Commission to generalize from the possibility of over-investment by some BOCs to a disallowance of embedded costs of other large LECs. Imposing a disallowance on small LECs, which are in an entirely separate category with very different network characteristics, based on such “evidence” would be totally inappropriate, lacking in substantial evidence,⁷³ and violating both fundamental considerations of due process and the prohibition on confiscation of investments prudently made.⁷⁴

⁷¹ See, Sidak and Spulber, “Deregulatory Takings and Breach of the Regulatory Contract,” NYU Law Rev. 851

⁷² NPRM ¶ 257.

⁷³ Electricity Consumers Resource Com. v. FERC, 747 F2d 1511, 1517 (DC Cir 1984).

⁷⁴ Duquesne Light Co. v. Barash, 488 US 299, 310, 317 (1989).

Accordingly, any disallowance of recovery must be based on company-specific findings of imprudence and may not be generalized from one company to another, much less from one group of LECs to another.

E. Embedded Investments Should be Presumed Reasonable Unless the Contrary Is Demonstrated by Another Party.

The NPRM also requests comment regarding the burden of proof and whether there should be presumptions involving the appropriateness of investments.⁷⁵ Clearly, there should be a strong presumption that all embedded investments made by LECs were prudently made and that the LECs should be allowed to recover those amounts. While some cost models assume perfect knowledge of customer needs and the deployment, at a single point in time, of the most efficient network facilities to meet those needs, the reality is far less favorable to LECs. LECs have been obligated to make investments and provide both universal service needs of end-user customers and the access service needs of IXC as those needs arose. Recovery of those investments from end user customers has been closely controlled by state regulatory bodies. Recovery of those investments from IXC have been closely controlled by the both Commission and state regulatory bodies.⁷⁶ The Constitution does not allow LECs to be deprived of recovery of their investments previously made where the risks result largely from regulatory decisions.⁷⁷

Similarly, there is no basis to conclude that current investments are no longer “used and useful.” To the contrary, it is obvious that embedded investments will continue to be used and that all parties recognize that the hypothetical network of various forward looking cost models

⁷⁵ NPRM ¶ 257.

⁷⁶ See, e.g. 47 CFR § 32.2000, 69.3, Minn. Stat. §§ 237.761, Subd. 3, 237.773, Subd. 4. This is particularly true for LECs that have remained subject to rate of return regulation of access rates by the Commission.

⁷⁷ Duquesne, 488 U.S. at 315.

will carry no actual access traffic. Rather, all access traffic will continue to be carried upon on the LECs' embedded facilities (until those facilities are actually replaced or alternative facilities are installed), irrespective of whether the LECs' investments in those embedded facilities are fully recognized in access rate development. It would stretch imagination beyond the breaking point to conclude that using the costs of a hypothetical network in a cost study somehow renders the existing network no longer "used and useful".

F. If a Shift to Forward Looking Costs Is Ordered, the Commission Must Establish a Mechanism for Recovery of The Difference Between Embedded Costs And Forward-Looking Costs.

The development and application of an appropriate recovery mechanism is critical if a shift to forward looking costs is required by the Commission. While adoption of the market-based approach would improve the prospects for recovery, it does not assure an appropriate opportunity for recovery of embedded costs.⁷⁸ Rather, a special recovery mechanism will be needed to operate in conjunction with either the market-based approach or prescriptive approach.⁷⁹ Certainly a mechanism for recovering accumulated under-depreciation is all the more necessary for incumbent LECs that have remained subject to rate-of-return regulation, and the calculation of any reserve deficiency cannot be cut off at the time of the enactment of the 1996 Act, because small LECs' depreciation practices remain controlled by the Commission.⁸⁰

G. The Accumulated Difference Between Embedded and Forward Looking Access Costs, Should be Recovered From IXC's.

It is possible that the difference between embedded access costs and forward-looking access costs could be recovered from the new universal service fund. If that were to occur,

⁷⁸ NPRM ¶ 261. The usefulness of the market-based approach is directly related to the amount of the accumulated under-depreciation.

⁷⁹ NPRM ¶ 262.

⁸⁰ NPRM ¶ 269, Dusquene 488 US at 315.

however, IXC's would receive a subsidy from other telecommunications service providers because the IXC's have been the direct "beneficiaries" of any under-depreciation required by the Commission and the states. If the recovery was transferred to the Universal Service Fund, a portion of the accumulated under-depreciation would be recovered from other providers in the telecommunications industry, including the LEC's. Such an approach would not be appropriate because, in effect, the portion paid for by the LEC's would still have been confiscated and should be avoided.

Rather, any accumulated under-recovery of investments in access facilities should be recovered from IXC's.⁸¹ An appropriate recovery mechanism from IXC's could be based on a charge per MOU or bulk-billed per dollar of revenue. Such an approach would be similar to the recommended approach for the universal service fund (which is based on relative revenue levels of all telecommunications carriers), but would be limited to the relative revenues (or MOU levels) of the IXC's.⁸²

VI. CONCLUSION:

Based on the foregoing, the Minn. Indpt. Coal. respectfully requests that the Commission:

1. Allow, but not require, rate of return regulated LEC's to change to a flat rate recovery of CCL from IXC's; ¶ 61
2. Allow small LEC's to use different mechanisms appropriate for smaller LEC's to determine the amounts to charge the respective IXC's for any flat rate CCL; ¶ 60

⁸¹ NPRM ¶ 264.

⁸² NPRM ¶ 264.

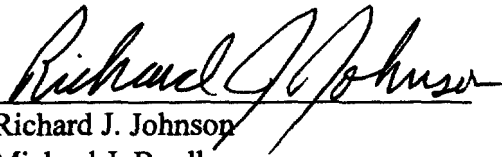
3. Determine that Section 254(g) precludes IXCs from passing through to their end user customers any deaveraged CCL charges that the IXCs may be required to pay to LECs; ¶ 63
4. Decline to forbear enforcement of Section 254(g); ¶ 63
5. Determine that IXCs are required to include in their averaged long distance rates any deaveraged access charges or deaveraged CCL charges that IXCs may be required to pay; ¶ 63
6. Determine that Section 254(c) does not require deaveraging of SLCs and continue averaging of SLCs; ¶ 67.
7. Avoid a higher SLC cap for second residential lines and for multiline businesses; ¶ 65
8. Allow, but not require, small LECs to implement peak/off-peak pricing for switched transport rates; ¶ 90
9. Allow, but not require, small LECs to implement per call set up charges. ¶ 89
10. Adjust transport rate levels for cost components that are readily identifiable, including adjustments to more accurately reflect MOU levels and DS1/DS3 usage in rural areas; ¶ 116
11. Allow all LECs an opportunity to recover all prudent investments, including any difference between embedded costs and forward looking costs; ¶ 256
12. Require any party that challenges the prudence of a LEC's investments to prove the imprudence on an individual company basis; ¶ 257

13. Require any party that challenges the continued used and usefulness of a LEC's investments to prove that the investments are not used and useful on an individual company basis; ¶ 257 and
14. Establish an appropriate mechanism to recover from IXC's any difference between embedded investments and forward looking investments, if a change to forward looking costs is implemented. ¶ 261

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Respectfully submitted,

MOSS & BARNETT
A Professional Association

By 
Richard J. Johnson
Michael J. Bradley
4800 Norwest Center
90 South Seventh Street
Minneapolis, MN 55402-4129
(612) 347-0275

Attorneys on behalf of Minnesota Independent
Coalition